

Power Markets Week
Day of the Trader '98

RTO Policy: Five Pitfalls FERC Must Avoid

by

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I. Introduction.

Good afternoon. We have come to a critical point in the restructuring of the electric industry. We have finally embarked upon a proceeding aimed at capturing the maximum regional efficiency from the transmission grid. Decisions we make in consultation with state commissions, and the industry as a whole, over the next few months may determine the structure of this industry for years to come. We are headed in the right direction, but it is by no means certain that we will reach the promised land. By failing to insist that grid regionalization efforts meet pro-competitive standards, we can blow it. If we want our actions to result in a vibrant competitive market for electric power, there are certain pitfalls we should avoid.

That is what I want to speak about today -- bad policy judgments we could make that would cause a failure to meet pro-competitive goals. What are the ways in which the Commission could blow this opportunity?

Two weeks ago, the Commission announced its intent to consult with state commissions on our use of authority under section 202(a) of the Federal Power Act with respect to the development of independent regional transmission organizations. This section of the FPA empowers and directs the Commission to divide the country into regional districts for the voluntary interconnection and coordination of generation and transmission facilities. This provision also requires the Commission to afford state commissions a reasonable opportunity for comments. Our notice

represents the first step in the process. The Commission intends to hold one or more conferences in January or February of next year to hear formally from the state commissions. We are eager to hear from the states on the policy choices that confront us.

Two and a half years ago when we issued Order No. 888, the Commission said that we would continue to review its success, and our orders expressly left the door open for additional policy changes as the wholesale market developed. As this 202(a) notice states, our experience since the issuance of Orders 888 and 889 leads us to believe that they alone may not be enough to achieve fully competitive power markets and open, non-discriminatory access to the transmission grid. Our notice initiating consultation recognizes impediments to full competition that exist today, such as lack of sufficient separation between generation and merchant functions, multiple pancaked transmission rates within a region, congestion management and loop flow issues, and generation market power that results when market size is constricted by transmission constraints. Many of these issues are ones with which Orders 888 and 889 did not even attempt to deal.

Rather than choose ISOs, or transcos, or gridcos, or some hybrid as the appropriate model, the Commission is using the term regional transmission organization. Over the next few weeks and months, as the debate evolves and our consultation with states and market participants continues, we must flesh out pro-competitive standards for such entities.

The question we have asked in this Notice is whether the goals of full competition and non-discriminatory access can be achieved in the absence of broad participation by transmission-owning electric utilities in regional transmission organizations. This is an excellent question, but it's not the only question. Will participation in any old type of transmission entity achieve these goals? What standards will we insist upon?

II. Five Potential Issue Pitfalls.

There are five key issue areas that will be critical to achieving our pro-competitive goals. If we fail in any or all of these areas, our efforts may bear little fruit. We could even move backwards.

An examination of these five key areas is the focus of my remarks today: (1) independence; (2) size; (3) operational authority; (4) incentives; and (5) full participation.

A. Independence.

The first critical issue is independence. Two years ago, the Commission declared that independence is the bedrock principle underlying our ISO policy. We have not retreated from a rigorous enforcement of this concept. We have insisted that the “I” in ISO have real teeth. Independence means that no market segment has improper influence on system operations. The fact that the Commission has introduced a new term in the debate -- regional transmission organizations or RTOs -- does not change the importance of the principle of independence.

We must remind ourselves that a key purpose of the formation of RTOs is to structurally separate the merchant and transmission functions of vertically integrated utilities. In other words, we want to mitigate the vertical market power that mere functionally unbundling has not reached. A transmission owner that owns generation has the financial incentive to use its transmission facilities to favor sales of its own generation. This is a strong economic incentive, and some utilities will not want to give up the opportunities to exercise vertical market power. Thus, they will attempt to play games with the issue of independence. They will test our commitment to the concept of independence.

For example, if a utility merely transfers its transmission assets to an affiliated transco, is this sufficient to mitigate concerns about vertical market power? Will FERC and market participants have confidence that such an affiliated entity will be fair and impartial? Is a cumbersome code of conduct separating the affiliates an effective substitute for true independence? We cannot forget the importance of the “trust” factor. If we don’t get the independence standards right, we are back where we started. We’ll be in the same soup we are in now -- lack of trust, concern over discrimination, and so forth. But it will be worse, because we will have spent lots of time and resources, both public and private, to facilitate the creation of new corporate institutions that fail this fundamental test.

One of our goals is more light-handed regulation of transmission. If we compromise the critical issue of independence and choose behavioral mitigation

measures such as codes of conduct, there will be no less regulation than what we have now. Overseeing the ledgerdomain of codes of conduct is very labor intensive and intrusive. We will act on complaints on a case-by-case basis; require complex rules for separating transmission and merchant employees; issue hundreds of orders acting on transmission owners' tariff filings; and direct our staff to conduct time-consuming audits of utilities records. Conduct regulation is not the least bit light-handed. We get little bang for the buck if we fail to insist on true independence, and accept conduct regulation instead. If we fail here, we will be chasing after bad conduct and overseeing business decisions for the foreseeable future. Is this what the industry wants?

B. Size.

The next issue that will test our mettle is size. Large RTOs will be critical to achieving our pro-competitive goals. Why is large size important? Transmission experts tell us that a system operator with a broad geographic reach will improve system reliability. A large grid management entity can internalize loop flow and redispatch constrained interfaces. Economists tell us a large RTO that eliminates pancaked transmission rates can increase the trading market by making more distant power economic. Small ISOs, single or double company transcos, and the like, simply won't cut it.

In this key area, I see three pitfalls that loom large in front of us. First, will the Commission fail to insist that RTOs are properly sized? In our September Midwest ISO order, the Commission stated that coordination in the public interest is best served if a proposed regional transmission entity is as large as possible. The order acknowledged that a large entity without geographic holes would be more reliable, more efficient, deal with loop flow across a larger and more contiguous region, and would eliminate the pancaking of transmission rates. To the Commission's credit, we accurately stated the reasons why large size is important. Nevertheless, we failed to take any action that would ensure a larger Midwest ISO without holes. Is this lack of political will the blueprint for the future? I hope not, but we will utterly fail if we merely espouse the right rhetoric by extolling the virtues of large institutions, but do not insist that RTOs are actually large enough to meet the Commission's pro-competitive goals.

Second, single state grid organizations have already developed and may be difficult to expand. Currently, we have operational ISOs in California and Texas, and have given conditional approval to one in New York. Arizona has a filing pending for approval of an independent scheduling administrator, and Nevada may be filing something similar soon. Many of these single state grid organizations are driven by state retail choice programs, and I fully appreciate and wholeheartedly respect the state's desire to get an organization in place to facilitate pro-competitive state programs. A single state ISO is infinitely better than no ISO. I am concerned, however, that these entities will get stuck at the single state level. If so, they may be hard to expand. I fear that market participants may see these as parochial and may therefore be reluctant to participate in these single state markets. The Commission must ensure that these single state organizations contemplate expansion to a more pro-competitive size.

The third pitfall to creating large RTOs is what I will call the "transco solution". The recent introduction of the term "RTO" is intended to signal that the label for the institution -- whether ISO, transco, gridco, or a hybrid -- is less important than whether the institution meets pro-competitive standards and goals. One of those goals is creating large, regional markets. I am concerned, however, that transcos may draw boundaries that are intended to fine-tune their monopoly power. The boundaries they draw may be an attempt to achieve control over key gateways of transmission commerce and serve as a tollkeeper to adjacent power markets. Frankly, the configurations that some transcos have described in their press releases would give gerrymandering a good name. Do these gerrymandered configurations coincide with system physics, loop flow or the size and shape of evolving power markets? I see no evidence of such rationale. How is reliability enhanced by these odd configurations? Do these configurations exaggerate rather than eliminate rate pancaking? They do not help create large markets for generation. Are they primarily an avenue to maximize transmission profits by exacting a separate toll for strategic transmission assets that must be used to reach the most active power markets? I fail to see the pro-consumer angle. Show me a transco the size and shape of, say, MAPP or SERC, and we'll talk.

If RTOs with holes or single-state RTOs, or gerrymandered transcos aren't the ideal, then what is the right size? How many RTOs would be ideal for North America? The opinions of transmission experts who have addressed the issue seem to range from three to a dozen. RTOs the size of the current regional reliability

councils would perhaps be a good start. It's critical to keep in mind, though, that nothing should be set in stone. We need to get the ball rolling and make sure that the initial designs do not contain any fatal flaws. The ultimate configurations should be designed by market participants, including the broad array of transmission customers, and owners, together with the state commissions and the FERC. The foundation for size standards must be reliability and large power markets. Nothing less should be acceptable.

C. Operational Authority.

We could have a perfect governance scheme that creates a truly independent RTO, and the RTO might be the right size without holes, but it won't matter very much if the RTO lacks the day-to-day and hour-to-hour authority to effectively and reliably operate the grid. In fact, the combination of strong governance with weak operating authority may be dangerous. It creates the illusion that we have accomplished something significant when, in fact, we haven't.

The Midwest ISO order indicated that the Commission had concerns that the Midwest ISO would not be a control area operator. The order acknowledged the concerns of those who argued that without this responsibility, there is no assurance the market power of transmission owners is mitigated. We asked the right question in the order: how much control is needed to provide reliable, non-discriminatory transmission? Nevertheless, we took no action. As I stated in my concurrence, we should have insisted on stronger ISO operational control and fewer control areas.

There are other important operational issues if an RTO is to be an effective system operator. Let me give a specific example in the area of transmission maintenance. The key question here is: Who determines the transmission maintenance schedule? Is it determined from the bottom up by the existing transmission owners? Or is it determined from the top down by the RTO? If maintenance schedules are from the bottom up, we run the risk that the RTO will be nothing more than a passive processor of annual and seasonal maintenance schedules submitted by the transmission owners. If transmission maintenance schedules are from the top down, what are the implications under Order 888, which says that the ISO (or RTO) is responsible for relieving transmission constraints? Does this imply that the RTO must change the maintenance schedule if it believes

that an alternate pattern of maintenance could reduce a potentially significant increase in market prices? For me, the answer is yes.

Transmission maintenance scheduling is, of course, just one area of real world operational authority. There are similar questions in almost all other areas of operations as well, including redispatch to relieve constraints, the acquisition and dispatch of ancillary services, and the calculation of available transmission capacity. It will be more and more important to know what effective operation means. And that inevitably means attention to specific operational issues.

I think the threshold question for FERC will be whether to enunciate additional standards that would flesh out the five Order 888 principles that deal with operating functions of an ISO. Such an important exercise will be challenging. We're still at the early stages of reform. There is the risk of "over specifying". We need to be sensitive to the fact there is already considerable regional variation. In the Northeast, ISOs are being grafted onto existing tight pools. In other regions, there is no pool to replace or complement. In some regions, the RTO may operate one or more electricity markets. In other regions, the ISO is specifically prohibited from operating any markets except those that relate to ancillary services. Any additional standards that define what is meant by effective system operation and control must be pragmatic and respect reasonable regional variation.

D. Incentives.

Now, I want to turn to whether the Commission should hand out economic incentives to transmission owners in exchange for their participation in RTOs. Some commissioners have raised this issue, and I want to state publicly my strong concerns about handing out sweeteners.

First, and fundamental to this debate is the question of whether it is necessary to dispense FERC candy to achieve our pro-competitive goals. If we believe that functional unbundling is insufficient to remedy unduly discriminatory behavior, why should the Commission bribe the formation of pro-competitive RTOs? Is not our authority under sections 205 and 206 broad enough to cure discrimination and preferential treatment? In Order 888, the Commission unanimously concluded that we had ample authority -- indeed a responsibility -- under section 206 of the FPA to

secure open access tariffs if we found such filings were necessary. The same principle is applicable here.

Second, if we pursue a policy that would give transmission owners FERC candy to join an RTO, what goodies do we give those transmission owners who are already members of current ISOs? Are they essentially penalized for coming in early? Or do we reopen and sweeten the transmission pricing schemes that we have already approved for existing ISOs?

Third, will the candy treats we give out be so great that they overshadow or even eliminate the consumer benefits that could result from our grid regionalization policies? I am concerned that sweeteners will substantially undercut savings to consumers from a competitive power market. Rather than bribing the formation of RTOs, we must emphasize the far larger benefits resulting from a grid regionalization policy -- a larger and more efficient market for generation plus a more reliable transmission system. There is no point to this exercise if our efforts do not ultimately benefit consumers.

Let me clarify one point, however. There is a difference between incentives as an inducement to participation in a RTO, which I oppose, and some form of efficient performance-based rates for RTO participants. I favor the latter, although, we need to recognize the complexities associated with effective performance-based rate proposals. There are many issues to address, including: what are the appropriate measures of output; what is an accurate measure of productivity; what services should be included or excluded; what level of an overall revenue cap should be set; and how should profits be shared.

E. Full Participation.

Now let me turn to participation. The success of any RTO will depend on getting the fullest participation possible. There must be a seat at the table for all transmission owners in the region including public power, the federal power marketing agencies, and rural electric coops. The exclusion of their transmission facilities from the RTO will diminish the full benefits that could be achieved.

Our policy must insist on inclusiveness and strongly disfavor exclusive transmission clubs. How do we ensure participation given our limited jurisdiction?

There are two concrete things we can do. We can insist that negotiations leading to the formation of RTOs are open to all market participants. Closed meetings, confidentiality agreements, limited notice of meetings -- these are not conducive to full participation. Exclusive, invitation only, secret transmission country clubs lead to suspicion and mistrust among those parties not invited to participate. We must strongly disfavor such organizations. Frankly, there is great concern that some transcos are being exclusively, rather than inclusively, structured.

We can also be sensitive to organizational structures and rules that might prevent public power from joining. Compliance with private use rules will be critical to the participation of public power. We should do what we can to remove impediments to full participation by public power in RTOs.

III. Conclusion.

I want to leave you with this final point. I am somewhat indifferent to the corporate form of an RTO. The jury is still out on what corporate form is best -- whether transco, gridco, ISO or a hybrid entity. I forcefully disagree with those who claim that the jury is already in, that for-profit transcos have won, that only a for-profit transco can reap real benefits for the marketplace. The arguments made by the for-profit transco camp are clearly one-sided. There is another side as well.

One of their arguments is that only for-profit entities can achieve great efficiencies because they alone will have the incentive to maximize throughput. I disagree. An ISO that operates the transmission facilities of several members will be required through its charter to run the grid efficiently and economically. It will have a fiduciary duty to its members to collect rates that have been approved by FERC, and its books and records will be subject to public scrutiny. It is bunk to argue that such an entity will not have the incentive to operate efficiently. Surely transco proponents don't mean that they will achieve more throughput by driving their systems harder and risk violating reliability rules. That's the only way they can squeeze more capacity out of the transmission system.

Another claim is that for-profit transcos will focus best on serving the needs of their customers, and that not-for-profit entities will not. This flies in the face of the positive track record of the hundreds of public power agencies and rural electric coops. Ask the customers of Basin Electric Cooperative, Oglethorpe, Salt River Project, Santee Cooper, or New York Power Authority whether these transmission

entities would operate more efficiently with a profit motive. A profit motive alone does not guarantee that customers' needs will be met.

For-profit transco champions argue that they are the best way to achieve light-handed regulation. But even if the for-profit transco has absolutely no affiliation with generation, the undisputed fact is that it will still be a monopoly. This Commission is not without experience in regulating the owners of monopoly assets. I think if you would ask the roughly 80 interstate natural gas pipeline companies if we regulate them in a light-handed manner -- the resounding response would be no.

It is argued that for-profit transcos will have a greater incentive to expand the transmission grid as compared to a not-for-profit entity. This may be true, and it is troubling. The Federal Trade Commission has argued that a for-profit transco would have the improper and inefficient incentive to favor only transmission solutions even when there are less costly and more efficient ways to relieve congestion? An ISO that has broad representation from all market participants may be in a better position to consider the needs of the region and present to state regulators a more persuasive and broadly supported case for system expansions when that is the most prudent method to relieve a constraint.

Because the Commission has yet not been presented with a concrete proposal by a for-profit transmission entity, much of this discussion is theoretical. I look forward in the future to evaluating a proposal that is filed with the Commission. Claims of efficiency made in press releases or speeches are difficult to evaluate objectively. Nonetheless, I remain open to different corporate structures, but the true test will be in how well they achieve the Commission's pro-competitive goals.

Transco proponents use the terminology of majestic creatures of flight to set our imaginations aflutter. Yet, if they believe that any old transco will do, even a single utility transco, affiliated with generation, that FERC bribes to make a filing, don't be fooled. Such an entity won't soar majestically. FERC must insist on independence, size and adequate operational control. I repeat, show me a transco filing that creates a truly independent entity and eliminates pancaked rates over a region the size of, say, MAPP or SERC, and we'll talk. No bribes, please, and make sure that public power and state commissions have a place at the table.

Anything less is simply not worth the candle!

Thank you.